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MEMORANDUM FOR: The Honorable Robert D. Hormats
Assistant Secretary for Economic and Business Affairs
Department of State

SUBJECT : Mexico: Financial Problems and Policy Adjustments

Attached is the analysis of Mexican external financial relations and the domestic economic situation that I promised you. The Mexican economic situation is still very fluid and sudden changes in policy can be expected. My analysts are following developments closely and will address major changes in the situation in Central Intelligence Agency publications and memoranda as they occur.

/s/ William J. Casey

William J. Casey
Director of Central Intelligence

Attachment:
As stated

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MEMORANDUM

SUBJECT: Mexico: Financial Problems and Policy Adjustments

Summary

Mexico's oil boom is over, and in its wake are galloping inflation and a huge and burdensome foreign debt. The growing economic and financial troubles could spill over into the social and political area if it is not soon resolved. To begin to solve the economic problems, harsh austerity measures must be implemented soon. President Jose Lopez Portillo, however, has sought to reduce the political backlash in an election year by keeping government spending, public sector growth, and consumption high. Meanwhile, Mexico has almost run out of foreign exchange, and has $10 billion in debt service obligations due during the rest of 1982. Thus far, most of the impact of the straitened financial conditions has been felt by the private sector, where heavy business losses and bankruptcies are emerging.

In the weeks prior to July's ritual election of ruling party candidate Miguel de la Madrid, Mexico City will go to great lengths to avoid cutting either social services and subsidies or private consumption. We expect to see some reduction of spending on highly visible public works, but this will not be allowed to go far enough to affect employment substantially. Short-term strategies to deal with the deepening foreign financial problems could include further sharp devaluation, the freezing of dollar accounts in Mexico, the imposition of exchange controls, or the strengthening of import controls.

After the election, policymakers in the lame duck administration will be more willing to introduce stricter austerity measures. The primary result will be a sharp slowdown in economic growth, with the return for 1982 as a whole running about 3 percent. Even so, inflationary pressures -- still fueled by previous expansions of the money supply and the impact of devaluation on import prices -- will remain high. If, however, austerity policies are not enforced, economic growth may hold at near 6 percent and inflation could explode into triple-digits.

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Beyond the end of the year, even this expansionary path would likely be cut off by foreign creditor resistance, and even sterner austerity measures would then be called for.

Over the longer term, the Mexican government must find the will to slow the pace of economic growth and rein in subsidies lest the remaining oil dividend be squandered. The consequences of this more sober course for the United States would include lower US exports to Mexico and might entail increased illegal migration and narcotics shipments. The alternative of continued reckless expansion would bode large losses for heavily exposed US banks.

* * *

Reaping the Oil Dividend

Since the mid-1970s, Mexico has fully spent its oil dividend and looked to foreign bankers for still more funds. During 1977-81, real economic growth averaged 8.5 percent yearly, with import volume pacing upward at 40 percent. Foreign bankers, attracted by the rapid development of large oil reserves, were willing lenders. In 1977-81, external debt tripled to $67.5 billion (40 percent owed to US banks) and pushed Mexico into the same league as Brazil, the largest LDC debtor. Soaring government spending soon collided with severe bottlenecks in productive capacity and skilled manpower; inflation passed the 25-percent mark in 1980.

The social benefits of this rapid economic growth and massive public spending were substantial. Enough jobs were created to prevent unemployment from increasing, even as new entrants flooded the labor force. In addition, the government was able to continue large-scale subsidies for consumers.

The Turning Point

To finance 8-percent economic growth last year, Mexico relied on higher oil revenues and a doubling of foreign and domestic borrowing. Exports were up more than 40 percent, to $14 billion, despite softening world oil prices and a dismissal of the PEMEX chief at midyear that disrupted new sales. Still, higher imports and debt service costs pushed the current account deficit to a record $11.7 billion. Even with the increase in merchandise imports, a $28 billion budget deficit (12.5 percent of Gross Domestic Product (GDP)) and tightening capital and raw material supplies boosted inflation to near 30 percent.

Success in securing foreign funds made Mexican policymakers reluctant to deal forcefully with progressive overvaluation of the peso. Despite the institution in October 1980 of a lagged crawling peg policy for the exchange rate, authorities held the change in the value of the Mexican peso relative to the dollar to less than 7 percent in 1981. Meanwhile, Mexican inflation exceeded that in the United States by 18 percent.*

In the face of these cumulating pressures, Mexico City also refused any other meaningful stabilization measures. In fact, seeking to end his presidential term without slowing the economy, Lopez Portillo at the end of last year presented a 1982 budget with a continued rapid expansion in government spending and a $40 billion budget deficit (16 percent of GDP).

Financial Pressures and Devaluation

In late 1981, Mexico City began to encounter mounting resistance from foreign lenders. Factors in the growing concern were the effect of the soft world oil market on Mexico's oil receipts; the sheer size of the foreign debt; and soaring budget deficits and inflation. As a result, Mexico City turned more and more to short-term, high-interest loans to finance imports.

By the beginning of 1982, Mexicans, too, lost confidence in government economic policies. As devaluation rumors mounted, they began converting pesos into dollars. Massive capital flight in early February and the sudden depletion of its international reserves forced the Bank of Mexico to float the peso on 17 February and draw down its $200 million first tranche with the International Monetary Fund (IMF). By the end of the month, the peso had depreciated 40 percent and was stabilized at about 45 pesos to the dollar, compared with 26.5 before. Since the end of February, the Bank of Mexico has managed the float, allowing the peso to slip four centavos each trading day, to the current 47 pesos to the dollar.

* For 1980, when the difference in inflation was 13 percent, the exchange rate had been allowed to depreciate against the dollar by only 0.5 percent.

Conflicting Statements and Practices

As the economy has continued to deteriorate, Mexico City has begun laying the groundwork for austerity, but without putting muscle behind policy statements. During recent campaigning, de la Madrid has emphasized the need for stabilization and anti-inflationary measures. Consistent with a Mexican tradition of statesmanlike acts in the closing months of an administration, Lopez Portillo appointed two of de la Madrid's close associates to key economic posts in mid-March in order to begin sharing economic policymaking authority. At the end of April, Mexico City announced its intention to move toward strict austerity. The particular goals that Mexico City set include:

- Trimming budgeted expenditures and boosting revenues through higher prices charged by public-sector enterprises.
- Cutting the public-sector deficit to 8.5 percent of GDP in 1982.
- Tightening monetary policy by limiting public and private credit.
- Holding net public sector borrowing to $11 billion, down from $15 billion last year.
- Reducing the current account deficit by $3-4 billion by cutting imports 25 percent.

Some of these targets -- especially those for public sector spending and borrowing -- were flatly overambitious considering ongoing programs and political commitments. Not surprisingly, implementation thus far has been disappointing.

Mexico's failure to deal resolutely with its financial problems has produced a mixed economic situation. So far, public funding for only a small number of highly visible construction projects has been cut. The attendant government demands for credit to cover the burgeoning peso deficit have, however, severely crimped private businesses' access to funds and slowed private sector growth to near 3 percent. Thus, in an accelerated version of the pattern of recent years, public sector spending has taken up a greater share of overall economic growth. Mexico City's policies have depressed private investment, buoyed consumption, contributed to reductions in private sector

inventories, and tended to spur imports. Although the substantially higher cost of imported goods since the February devaluation has probably slowed new orders, past orders have kept imports -- and the current account deficit -- up. Furthermore, the wage settlements have actually reduced the relative costs of foreign goods for many wage earners and given another spur to Mexican travel to the United States and to border purchases.

This continuing expansion is a major part of Mexico's financial and liquidity problems. Questions about the government's willingness and ability to move beyond tight monetary policies to cut government spending -- the key to an austerity program -- have caused another round of capital flight. The government has postponed taking the harsh measures needed for fear that hitting the consumer with sharply higher prices, labor with fewer jobs, and business with reduced public sector orders and closed projects would focus discontent on the ruling Institutional Revolutionary Party (PRI).

The result has been an immediate foreign liquidity crisis. After rebounding somewhat following the devaluation, Mexico's foreign exchange reserves have fallen steadily and are now even lower than in February. At the same time, loan syndications from private bankers have become increasingly expensive and difficult to obtain. A $2.5 billion foreign private syndication is now being put together, but funds from it will probably not be available for some weeks. Beyond money now lined up or being negotiated, Mexico City needs at least another $1 billion to bridge it past the 4 July election. To come up with additional funds, Mexico City is anxiously casting about for possible new oil sales or nonrestricted official loans. Moreover, even with no real prospect of success, Mexico is trying to secure a $1 billion advance on its $2.5 billion syndication.

The Election Gantlet

Despite these pressures, Mexico City probably will not change domestic policies before the election. In a three-hour television interview in mid-May, Lopez Portillo again reaffirmed his unwillingness to fight inflation by reducing demand and sacrificing jobs. Moreover, he added that during this time of financial stress, the government had the obligation to stand behind those who could afford it least and by taking steps to assure that consumption for the poor does not fall.

The government especially wants to avoid any reduction in organized labor's support in the midst of an election campaign. Indeed, it was Lopez Portillo who overrode private sector objections to granting the recent large wage increases to labor. His decision reflects an awareness that, for the last five years, workers have suffered a loss in real wages and that, as the ruling party's largest sector, labor traditionally plays a major role in mobilizing support for party candidates.

The lack of popular enthusiasm for the PRI presidential candidate de la Madrid and growing public criticism of the government's recent economic moves have reinforced party leaders' perceptions of vulnerability. Although de la Madrid is certain to win the election, these leaders -- mindful of the difficulty he has had in establishing rapport with labor -- fear that additional austerity measures would result in high voter absenteeism and a substantial protest vote for opposition parties. This would seriously embarrass the government and complicate the task of the incoming administration in grappling with economic difficulties and other issues.

Possible Strategies for the Short-Term

Diffident about measures that affect domestic consumption, the Mexicans will probably be willing to act on the foreign financial side to buy a bit more time. The Bank of Mexico may soon be forced to withdraw from the foreign exchange market and once again devalue the peso. Under current market conditions, the peso would drop sharply -- perhaps to as much as 70 pesos to the dollar. The Mexicans want to avoid such a step, arguing that the peso is already undervalued; still this course is quicker-acting than toughness at home on public spending or incomes policies.

An alternate step would be freezing Mexican dollar accounts -- now totalling some $12 billion -- and imposing import and exchange controls. While freezing dollar accounts would be relatively easy, exchange controls would be difficult at best to enforce and therefore might not substantially slow capital flight. Moreover, both of these steps would undermine critically needed capital inflows. Nevertheless, such measures might allow Mexico City to get by until the election without invoking harsh austerity measures.

Beyond the Election: The 1982 Outlook

If the government moves quickly following the July election and adopts measures to implement the April stabilization strategy, lower growth in the public sector -- perhaps as soon as early fall -- could take pressure off the peso and contribute to a further slowing of imports. Among the steps that the government will probably take first is putting aside or postponing showcase development projects (such as the ambitious nuclear power program and regional rural development projects). Also, sharp cuts in food and fuel subsidies will be necessary.

Performance under this scenario for 1982 will look substantially worse than for 1981.

- Overall, real economic growth for the year would post about 3 percent.

- Inflation -- on the order of 60 percent -- would be at least double that of last year.

- Unemployment would be up sharply, with increases in worker unrest likely.

The major gain from these sacrifices will be a subsidence in the current account deficit from 1981's $11.7 billion to something near $8 billion.

The private sector would continue the slowdown that is now amply evident. The squeeze from public borrowing, higher wages, and local currency requirements for foreign debt servicing obligations have already slashed the funds available to it for imports of raw materials and capital goods. Construction and manufacturing will continue to be hardest hit. Mexico's largest private company -- Alfa Industries -- a steel, chemical, and consumer goods conglomerate is in serious trouble and has already had to slash not only its investment programs, but also maintenance expenditures and other current spending.

Compared with 1981, consumer price inflation will almost certainly double because of lower imports, the steep peso devaluation, vastly higher wages, and the still high government deficit. During January-April prices were already up 19.2 percent -- 69 percent on an annualized basis -- and there is likely to be no substantial change in spending and credit policies this quarter. Even with the introduction of austerity

measures in the latter half of the year, reduced foreign borrowing will require Mexico City to rely increasingly on expansion in the money supply to finance the budget deficit. Regular wage adjustments and the large government-mandated supplemental wage hike, designed to maintain workers' purchasing power, have already boosted wages up to 75 percent above the level at the end of 1981. Efforts to slow inflation by broadening price controls have had limited success, and will be increasingly ineffective as the money supply skyrockets and imports fall over the next few months.

The soft world oil market is curbing the growth in export earnings this year, despite an improved outlook for non-oil sales. If world oil prices stay near the current low level and Mexico increases foreign oil sales by 200,000 b/d to 1.3 million b/d, petroleum export receipts would about equal last year's $14 billion. Oil exports could not go much higher even if a market could be found. As a result of sharp cuts in oil exploration and development spending since last June, neither production nor export capacity will increase substantially during the remainder of the year. In contrast, the realignment of the peso is encouraging exporters to boost exports of manufactures, farm products, and minerals. For 1982, these exports probably will increase by $1 billion, to $7.7 billion.

Mexico's import boom is ending as the government tightens import controls and foreign borrowing lags. A record grain harvest last year is allowing Mexico City to slash food imports by one half from last year's $3 billion. The import crunch is limiting investment because imported capital goods have accounted for 70 percent of total investment in machinery and equipment in 1980-81. This impact is falling disproportionately on the private sector, which has received the bulk of capital goods imports in recent years.

Until Mexico City begins to make real progress in stabilizing the economy, foreign bank loans will become harder to get. Even if oil exports continue to cover current merchandise imports, Mexico City still needs to line up $10 billion more this year to service its medium and long-term debt (interest and amortization). In addition, Mexico City has another $16 billion in short-term debt, which must be rolled over, rescheduled, or paid off. To do this, Mexico City may well be forced to resort

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to the IMF. A three-year, $4 billion IMF package could bring in $1 billion in 1982. More important, it would encourage private and official creditors to be more responsive.

The Cost of Continuing Expansion

Mexico City faces a difficult road. If it fails to implement real austerity soon after the July elections, the outlook would be substantially worse. At the limit, higher economic growth -- around the current 5 percent -- could be held for as much as 6-9 months. For 1982, this would mean 80 to 100 percent inflation and a current account deficit at least equal to last year's $11.7 billion.

The principal reason such policies could not last is that foreign creditors would abandon Mexico. Even should it resort in the extreme case to running down whatever exchange reserves remained and defaulting on debt, the Mexican government would ultimately be forced to reduce imports sharply. This would entail losses of critical producers goods and raw materials, and production would contract drastically. Coming out of this chaos would require the restoration of foreign creditworthiness, which could only be achieved through the imposition of austerity more stern than that now necessary and at the cost of much higher interest spreads.

The Pivotal 1982 Borrowing Gap

If -- as we expect -- foreign creditors become increasingly sticky with Mexico no matter what its policies, the prospects for continuing rapid growth will be bleak under any scenario. Accordingly, any comprehensive plan to deal with this year's remaining $10 billion foreign exchange gap will entail some policy accommodations. To qualify for a broad-gauged rescheduling exercise and a $1 billion emergency loan from the US Treasury and the Federal Reserve, Mexico City would first have to receive formal IMF support for its stabilization program. The government will try to avoid debt rescheduling because it would further worsen Mexico's credit rating. On the other hand, any delay in paying back debt would raise the cost of loans to Mexico and at the same time sharply limit new foreign credits for at least the following two years.

Prospects for the Longer-Term

The new administration, which comes into office on 1 December 1982, will have to face up to Mexico's basic economic problems. It must balance the need for austerity policies that satisfy the international banking community with the need for domestic economic growth to generate jobs.

De la Madrid will find it even more difficult to sustain subsidies and political rewards on a basis commensurate with those of the last four years, when economic growth exceeded 8 percent annually. With unemployment and inflation surging, tensions between the government and labor would mount. The PRI, locked into its historic platform of promising jobs and increasing consumption, would begin to come under severe pressures, possibly including increasing strikes, student demonstrations, and /or violent consumer protests.

Still, the government's ability to fund the kind of economic growth needed to absorb the large increments to the labor force will be limited in the next few years by the soft world oil market. Even with an all-out program to expand oil production capacity, the market will limit what Mexico can earn; indeed, Mexico will do well just to maintain the purchasing power of its oil earnings. If world oil prices fall further, the strains on the financial, political, and social fabric will be magnified.

The competitive position of other export industries and tourism has been seriously weakened in recent years by Mexico's rapid inflation. Even with the devaluation, continuing depreciation will be required to maintain competitiveness. Moreover, for the next several years, the high debt service payments will take about half of foreign exchange earnings.

Avoiding chronic financial crises will require several years of austerity. This, in turn, would necessitate well-coordinated economic policies and political resolve in the face of continuing rapid expansion of the labor force. Mexico's difficulty in dealing with day-to-day financial problems in the last few months raises questions about the government's willingness to make more fundamental economic adjustments as the oil dividend shrinks. So, too, does its laxness on domestic oil conservation policies. Like the devaluation, the other major economic policy move of hiking domestic gasoline prices in December 1981 was only halfhearted. After the hike, overall Mexican energy prices were

still just one-third the comparable US level, even though rising domestic energy consumption is expected to eat into the exportable oil surplus late in the decade. Since the devaluation, relative domestic oil prices in Mexico have slumped to just one-sixth the US level.

The recurrence of a financial crisis within six years of the 1976 upheaval suggests underlying structural problems that will haunt the Mexicans. So far, the government has demonstrated only limited willingness to respond to economic signals. A key factor in Mexico City's ability to quickly carry out necessary programs is the extent to which the oil boom of the past few years has eroded the ruling party's power to coopt diffuse elements within Mexican society. If Mexico City persists in demonstrating the absence of political mettle required to enforce economic policy changes, it risks the continual use of a substantial portion of its oil dividend on debt service and domestic subsidies rather than on productive, job-creating investments.

Implications for the United States

From here out, US interests will be seriously affected no matter what Mexico does. The longer Mexico City procrastinates, the more severe the effects.

Whatever policy course Mexico adopts, managing its foreign debt will require continuous banking support. The Mexicans will undoubtedly look to the United States for backing if they encounter a severe financial crisis. For their part, US private bankers will almost certainly reduce new lending activities in Mexico over the next two years, and may well be faced with restructuring their credits and postponing debt service. If Mexico City needs to resort to the IMF, it would also request drawings on $1 billion in standing emergency loans from the US Treasury and Federal Reserve. 25X1

US business operating in Mexico for the domestic market -- the majority of the $7 billion US investment -- is in for a harder time. Heavy use of devaluations and generous wage settlements are causing growing losses. Expected sharp increases in the price of industrial fuels and other intermediate goods could hurt even more. Even those US assembly businesses processing goods on the border for re-export to the United States will tend to stagnate because higher wages and input costs will offset much of the beneficial effects of the devaluation.

The economic slowdown will cut Mexican imports and per-capita income. As a result, over the next few years US exports to Mexico probably will be about $3 billion below the $17.8 billion for 1981. Many Mexican citizens will try to maintain consumption in part by increasing illegal work trips to the United States. Stepping up production and trafficking of narcotics can also be expected. On the other hand, Mexico's financial requirements could make US access to Mexico's oil and gas easier to negotiate.

Any perceived US insensitivities or inaction on financial and economic policy issues could spill over into other bilateral political relations. At a minimum, the increasing domestic and social tensions in Mexico that attend slowed economic growth may give rise to more frequent and open criticism of US policies by the Mexican press and politicians.

There are also serious implications -- not all bad -- for Mexican participation in multilateral relations. The need for Mexico City to concentrate on economic management will probably cause de la Madrid, at least initially, to devote relatively less attention to international issues.

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